

Food & Marketing



Dairyfield Magazine

Federal Milk Marketing Orders: Consolidation & Reform

The 1996 Farm Act included two significant changes under the Dairy title as part of the effort to reduce government intervention and regulation of agriculture and to move agriculture toward a greater market orientation. The first of these was the phasing out of the dairy price support program, which for years established the minimum price for milk; the second was the requirement that the U.S. Department of Agriculture (USDA) consolidate and reform the Federal Milk Marketing Order (FMMO) system.

The law mandated that USDA reduce the number of milk marketing orders from 31 to no less than 10 and no more than 14 by April 4, 1999. USDA announced publication of the proposed rule on January 23, 1998, to solicit public comment on proposals for consolidation of the order system, changes to classified pricing, replacement of the Basic Formula Price, and changes in order provisions, terminology, and classification of milk by end-use.

The FMMO system was set up in the 1930's when milk producers had no alternatives to selling their milk to local handlers and were often captive to unfair buying practices by milk dealers or handlers. FMMO's were designed to level the playing field by returning some market power

to producers. A milk marketing order—which covers only Grade A milk (about 95 percent of milk production)—is a geographically defined fluid milk demand area. Within each region, handlers' milk sold in the milk marketing order is "pooled" to generate a uniform average price, called the blend price.

FMMO's set monthly minimum prices (classified pricing) for different uses of milk. Class I milk is milk for fluid consumption; Class II milk is used to produce soft products such as ice cream, cottage cheese, and yogurt; and Class III milk is used to manufacture hard products such as butter, nonfat dry milk, and cheese. In recent years, many marketing orders have also defined a Class III-A category for milk used to make nonfat dry milk.

The minimum prices for Class I and II milk are determined by adding fixed differentials to the Basic Formula Price (BFP), which is based on the old M-W (Minnesota-Wisconsin) price, updated by a product price formula. The BFP also currently serves as the Class III price. The current Class II price is constant over all marketing orders at 30 cents above the Class III (BFP) price. The Class I differential varies for each milk marketing order; generally, the Class I differentials

increase from northern to southern markets, ranging from a low of \$1.20 in the Upper Midwest to a high of \$4.18 in Miami, Florida.

Data are collected within each marketing order on the quantities of milk used in each class of milk in the order. A blend price, or average, is calculated based on the class prices and the quantities used in each class. The blend price becomes the minimum that handlers must pay producers or producers' cooperatives. Since all handlers must purchase at the minimum class prices, handlers who produce cheese, butter, and nonfat dry milk ultimately receive payments back from the marketing order pool to compensate for the difference between the blend price and the lower Class III and III-A prices. In contrast, Class I and II handlers must pay into the pool the difference between the blend price and their higher class prices.

How Does Order Reform Affect the Present System?

In the 1996 Farm Act, USDA was directed to consolidate the milk marketing orders, which will generally enlarge the area and expand the number of producers and handlers covered by a typical order. USDA's proposed rule would consolidate the present 31 orders into 11.

No orders would remain geographically unaffected, although some orders would see only minor changes. The Arizona order, for example, has only a minor change—the addition of the Las Vegas area. Nine orders in the proposed rule combine at least two orders from the former system, with some combining as many as five. The new order also would include some previously unregulated areas. All

Detailed information on economic impacts of FMMO reform, as well as the text of the proposed rule and other supporting material, are available on the internet at <http://www.ams.usda.gov/dairy/reform>. Or contact USDA-AMS Dairy Programs, P.O. Box 96456, Washington, DC 20090-6456

producers will be able to vote on the final orders after the final rule is published.

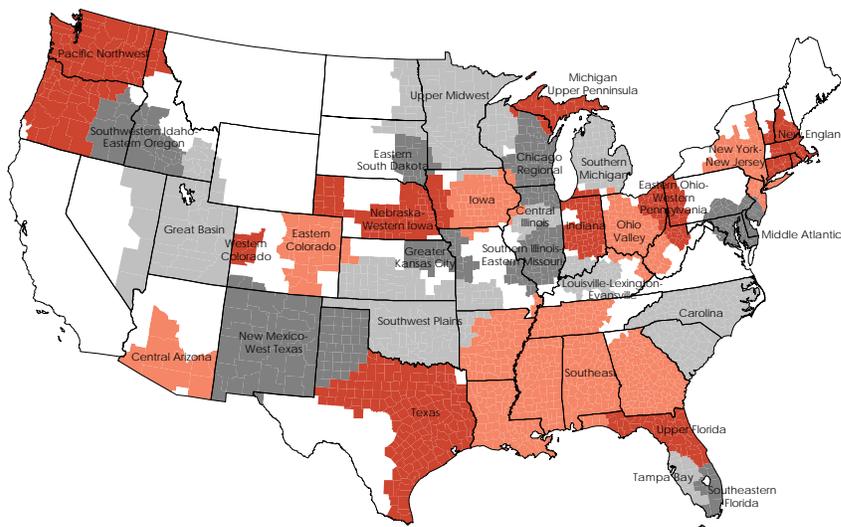
The 1996 Farm Act also granted California dairy producers—who have a separate state milk marketing order—the right to vote to join the FMMO system as a separate order. USDA’s proposed rule does not include California, since a petition from the state’s producers to be included in the FMMO system was not received in time to be evaluated before issuance of the proposed rule in January.

In conjunction with the consolidation, USDA was authorized to consider several other changes to FMMO’s, including multiple basing points. In the current order program, the price surface has traditionally recognized the Upper Midwest as the dominant surplus milk production area or basing point. In the proposed rule, USDA now recognizes multiple locations as surplus production areas, and the price surfaces under the proposed pricing options reflect these multiple basing points.

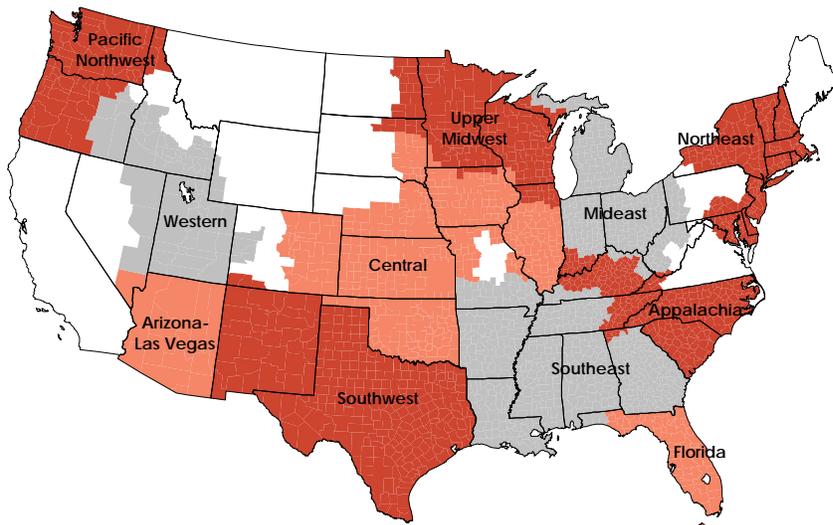
In the proposed rule, seven different price surface options are presented, two in significant detail. Option 1A is based in part on results generated by a model created at Cornell University, adjusted for more recent economic conditions. USDA expresses a preference for one option, called Option 1B in the proposed rule, which is a more market-oriented price surface also generated by the Cornell model. Option 1B would be phased in over a 5-year period, with the new Class I differentials in each marketing order phased in by 20 percent each year until the new differentials are reached. Two other phase-in methods for Option 1B would provide compensation to producers by adding a fixed amount to the Option 1B differentials over the 5-year phase-in period.

Other options analyzed in the proposed rule include a proposal by Mid-American Dairyman, Inc., which leaves the differentials unchanged from the current system but would floor the BFP at \$13.63—the record level established in 1996. An option proposed by the International Dairy Foods Association (IDFA) would change the price surface for Class I milk and have only two class prices—fluid milk and other milk.

Current Federal Milk Marketing Order System Uses 31 Marketing Areas



Proposed Consolidation Would Create 11 Marketing Areas



Blank areas are not covered by Federal Milk Marketing Order System

Source: NY-NJ Milk Marketing Area, Agricultural Marketing Service, USDA.

Food & Marketing

Classified Pricing Changes Under Federal Milk Marketing Order Reform

Current System	Proposed
<i>Class I price</i> = Class III or Basic Formula Price (national price) + Class I differential (order specific)	<i>Class I price</i> = higher of Class III price (national price) or Class IV price (national price) + Class I differential (order specific)
<i>Class II price</i> = Basic Formula Price + \$0.30/cwt (national)	<i>Class II price</i> = Class IV price (national price) + \$0.70/cwt (national)
<i>Class III or Basic Formula Price</i> (national) Minnesota-Wisconsin Grade B price updated by a product price formula	<i>Class III price</i> (national) Formula based on butter, cheese, and whey prices
<i>Class III-A</i> (national) Formula based on nonfat dry milk prices and the butterfat differential	<i>Class IV price</i> (national) Formula based on butter and nonfat dry milk prices

The 1996 Farm Act also authorized USDA to consider multiple component pricing for developing prices for milk used in manufacturing products. Under USDA's proposed rule, component prices (protein, butterfat, and other nonfat solids) would be used to determine the values of milk used in Class III (milk used in cheese) and a new Class IV (milk used in butter and nonfat dry milk). USDA would use information on market prices for cheese, butter, nonfat dry milk, and whey to determine the values of milk components and determine minimum prices using formulas that incorporate these component values. In recent months, the proposed Class III price has been running above the current BFP and the proposed Class IV price above the Class III-A price. The new Class II price would be set at 70 cents above the Class IV price versus 30 cents above the Class III price currently. Recent experience also suggests the Class I price would increase.

What Will Be the Economic Effect?

Consolidation has two basic impacts on the blend prices received by producers. First, utilization rates (the relative use of each class of milk) change when orders are combined—some old orders will bring lower Class I utilization to new orders, lowering the basic blend price, and vice versa. The second, and less obvious, change relates to the “zoning” of blend prices under an order. Zoning is the practice of setting the blend prices differently at rural and urban processing plants within a marketing order to encourage the movement of milk to urban areas to satisfy the demand for fluid milk. In effect, the blend price at a rural processing plant is set to reflect the cost of moving milk to urban areas and plants, compensating producers for supplying milk to where it is needed.

An analysis of changes in three hypothetical orders provides an example of how the

consolidation and zoning may affect the producer blend price. Under the current system, the differences between the Class I prices in these hypothetical marketing orders are around 10 cents—Order A is about 10 cents higher than Order B, and Order C is about 10 cents lower than Order B. Because the Class I utilization in each of these orders is about 50 percent, the effective differences between the blend prices at the base points in each separate marketing order under the current system would be about 5 cents between A and B and between B and C. When the orders are combined, B's base point becomes the base point for the new order. Thus, the new zoned blend price for A is 10 cents higher than the B price, and the blend price for C is 10 cents lower than the B price, a change of 5 cents for each.

Changes in the Class I price surface will affect producer revenues and consumer costs, although the final effect will be determined by how much milk is used in Class I products (Class I utilization). In economic terms, the effect of classified pricing can also be called price discrimination. Under price discrimination, higher prices can be charged for the same raw product in the market with a more inelastic demand (i.e., where a 1-percent change in the price of that product will result in a less-than-1-percent change in the quantity of that product demanded).

To increase revenue in a market with inelastic demand, a seller can either raise prices or reduce supply. Since the demand for fluid milk is more inelastic than the demand for milk for manufacturing, under a higher Class I price surface, revenue in the fluid market will increase, despite lower quantity consumed. The reduction in the quantity demanded in the fluid market due to higher prices will create a larger supply in the manufacturing market, which could reduce the revenue to producers in this market.

Milk Pricing Options Under the Federal Milk Marketing Order Reform

Option	Phase-in period	Base price at Minneapolis, MN	Price surface	Number of classes
1-A	No	\$1.60	Based on Cornell model analysis as changed by AMS price surface committee	Class I (fluid), Class II (soft products), Class III (cheese), and Class IV (butter and dry milk)
1-B*	5 years	\$1.20	Based on Cornell model analysis without changes made by AMS Price surface is flatter than 1-A	Class I (fluid), Class II (soft products), Class III (cheese), and Class IV (butter and dry milk)
5	No	\$1.20	No change in price surface from present levels	Class I (fluid), Class II (soft products), Class III (cheese), and Class IV (butter and dry milk) Class III price for Class I pricing would be floored at \$13.63
6	5 years	\$0.99	Price surface proposed by International Dairy Foods Association	Class I (fluid) and Class II (all other milk)

*Option 1-B has two sub-options, one of which would compensate producers for lost income over the phase-in period. The other would provide additional compensation.

The revenue increase in the fluid market would be greater than the revenue loss in the manufacturing sector. As a result, consumers would pay more on average for dairy products, and producer incomes would increase. Regionally, producers in areas with high Class I utilization will gain more from higher Class I differentials. Producers in areas with low Class I differentials will gain less. Since Option 1B eventually results in lower Class I prices overall, Option 1B may return less income to dairy farmers and lead to lower consumer expenditures for dairy products compared with Option 1A.

The proposed Class III and Class IV prices will also affect producers and processors. At the present time, it appears that the proposed Class III and Class IV prices would be higher than their predecessors. Thus, the new order system could raise the cost of milk going into the products using these classes of milk. A second impact of higher Class III and Class IV prices will be higher Class I and Class II prices than would have occurred under the current price formulas.

USDA will be accepting comments on its proposed rule through April 30. These comments will be reviewed and a final rule will be announced, followed by informational meetings and a producer referendum early next year.

Richard P. Stillman (202) 694-5188
stillman@econ.ag.gov 